IN THE

Supreme Court of the United States

OCTOBER TERM, 1923.

No. [redacted]70

HERMAN G. GERDES, as trustee in bankruptcy of ABRAHAM LUSTGARTEN, Bankrupt,
Petitioner,

—against—

ABRAHAM LUSTGARTEN,
Respondent.

BRIEF AND ARGUMENT FOR PETITIONER.

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STATEMENT OF CASE.

This case comes before this Court upon a writ of certiorari to review an order of the Circuit Court of Appeals, Second Circuit, which reversed a decree of the District Court and instructed the District Court to grant a discharge in bankruptcy to Abraham Lustgarten.

An involuntary petition in bankruptcy was filed against Abraham Lustgarten, on the 1st day of March, 1921, and an adjudication followed on the 4th day of April, 1921. The bankrupt applied for a discharge and certain creditors entered appearances and filed specifications of grounds of their opposition to the bankrupt's application. Pursuant to order duly made, petitioner was authorized to prosecute the objections to bankrupt's application upon the specifications filed by creditors.

Four grounds of opposition were specified,to-wit: (1) that with intent to conceal his financial condition, the bankrupt had destroyed, concealed or failed to keep books of account or records, from which such condition might be ascertained; (2) that he had obtained money or property on credit upon a materially false statement in writing made by him; (3) that he had, subsequent to the first day of the four months immediately preceding the filing of the petition, transferred, removed or sold, or permitted to be transferred, removed or sold $2,000 in value of his property, with intent to hinder, delay or defraud his creditors; (4) that he had committed offenses punishable by imprisonment as provided in the Acts of Congress relating to Bankruptcy, in that he knowingly made a false oath in the bankruptcy proceedings (Rec., pp. 3-6).

The following facts appear from the evidence adduced to support the specifications: On January 5, 1920, the bankrupt delivered to the Corn Exchange Bank a financial statement (Trustee's Ex. 1, p. 66) reflecting his condition as of December 15, 1919, which financial statement showed the bankrupt to have a net worth on December 15, 1919, of $58,135.89. It was proven by the bankrupt's books of account that on December 15, 1919, his net worth was $23,158.43 indicating that the financial statement was inflated to the extent of $32,388.46 (pp. 24-25).

This financial statement contained the following:

> "This statement is to be regarded by Abraham Lustgarten and by the Corn Exchange Bank as continuous and binding, and to form a true statement of the assets and liabilities of the undersigned, and other matters to be relied upon by the Corn Exchange Bank upon application by the undersigned for all loans until another statement shall be substituted for this or this statement recalled * * * *and further whenever my financial condition is changed materially from the financial condition shown in the above statement, I agree to notify the said bank at once of such change whether applications for further loans are made or not*" (p. 67).

The financial statement contained the following figures:

ASSETS.

Merchandise	$39,004.97
Accounts Receivable	30,642.50
Cash in Bank	9,042.79
Cash on hand	945.63
Fixtures & Machinery	1,500.00
Total	$81,135.89

LIABILITIES

For Merchandise	$ 3,000.00
For Bank Accommodation	20,000.00
Total	23,000.00
Net Surplus	$58,135.89

The items claimed to be falsified were "Merchandise $39,004.97" and "Accounts Receivable $30,642.50," and were proved false by comparison with the bankrupt's books of account which showed the bankrupt's merchandise to be $24,721.17 (p. 24) and accounts receivable to be $9,053.25 (p. 24).

The bankrupt attempted to explain this discrepancy by testifying without referring to or supporting his statements by any records that the inventory of $24,721.17 shown on his books, consisted of piece goods, and because of the faulty method of bookkeeping, this inventory failed to include linings, silks, satins, velvets and manufactured goods, coats, suits, dresses and capes, and also failed to include paper-boxes, wrapping paper, twines, trimmings, stationery and printing, and that although the books showed an inventory of only $24,721.17 he did have merchandise inventoried at $39,004.97, the amount shown in the financial statement.

Likewise the discrepancy in the outstanding accounts is explained by faulty bookkeeping claimed to be due to the failure of the bookkeeper to enter upon the books items of merchandise outstanding with salesmen, merchandise outstanding with customers shipped on approval, and merchandise shipped to customers and not entered in the books, the sales having been made a day or two before the closing of the books and of which sales memoranda were entered upon slips of paper on the bookkeeper's desk and not carried into the books (pp. 37-38).

The Corn Exchange Bank extended credit to the bankrupt on October 29, 1920, November 4, 1920, and February 11, 1921, no notice having been received by the Bank of any change in the financial condition of the bankrupt and the statement not having been recalled (pp. 14-26).

The bankrupt paid to one Louis Lustgarten, a nephew, the sum of $2,000 within three months prior to the bankruptcy (Rec. 23, fol. 38). The record of this payment appears in the general ledger, page 45, under the heading of "Commissions on Sales." No entries appear in the bankrupt's books showing any indebtedness to Louis Lustgarten and no entry appears in the salesmen's commission book indicating that Louis Lustgarten was entitled to receive any commissions (Rec. p. 24, fol. 38). The bankrupt testified that said nephew was employed in the bankrupt's business during the year 1919 at a salary of $50 and in 1920 at a salary of $60, and that the bankrupt deducted $20 each week from said nephew's salary and held same as savings for him. In December, 1920, the nephew requested payment of his savings and $2,000 was paid to him (Rec. p. 65, fol. 103). The only entry in the books of the bankrupt is an entry of

payment as follows: December 8th, $1,000; December 22nd, $1,000, which entries appear in the cash book and also appear to be posted in the general ledger under the heading "Commissions on Sales" (pp. 23-24, fol. 38). Nothing appears in the books as a credit to offset these debits (fol. 113).

The Special Master did not pass upon the question of fact involved in the determination of whether the financial statement was in fact false, holding that it was unnecessary for him to do so under the decision of the Circuit Court of Appeals, Second Circuit (B. & R. Glove Corporation, 279 Fed. 372); and that under the decision of the Circuit Court of Appeals, the Corn Exchange Bank had no right to rely upon this statement in extending credit after a period of ten months elapsed from the date of the statement (Rec. p. 2); and the Special Master found in favor of the bankrupt upon the facts with respect to the specifications of fraudulent concealment of $2,000 from the trustee in bankruptcy and failure to keep proper books of account. The District Court reversed the Special Master and sustained the specifications as to the false financial statement and as to the failure to keep proper books of account (Rec. 68). The Circuit Court of Appeals reversed the District Court and sustained the Special Master (p. 72).

Petitioner respectfully submits that the Circuit Court of Appeals erred in respect to the matters set forth in the following specifications of error.

SPECIFICATIONS OF ERROR.

1. The Circuit Court of Appeals erred in reversing the order of the District Court which denied the bankrupt a discharge.

2. The Circuit Court of Appeals erred in holding that the Corn Exchange Bank was not justified in relying upon the bankrupt's financial statement when it extended credit thereon.

3. The Circuit Court of Appeals erred in holding that its decision in *B. & R. Glove Corporation*, 279 Fed. 372 was decisive of this case.

4. The Circuit Court of Appeals erred in holding that the bankrupt's failure to enter in his books the alleged indebtedness to his nephew, Louis Lustgarten, and the entry of the payments to Louis Lustgarten did not constitute a failure to keep books of account or records within the requirements of the Bankruptcy Act.

POINT I.

THE PROOF ADDUCED BY THE PETITIONER ESTABLISHED THAT THE BANKRUPT, WITH INTENT TO CONCEAL HIS FINANCIAL CONDITION, OBTAINED MONEY OR PROPERTY ON CREDIT, UPON A MATERIALLY FALSE STATEMENT IN WRITING MADE BY HIM FOR THE PURPOSE OF OBTAINING CREDIT. THE CORN EXCHANGE BANK WAS JUSTIFIED IN RELYING UPON THE FINANCIAL STATEMENT ISSUED BY THE BANKRUPT, NOTWITHSTANDING THE LAPSE OF TEN MONTHS BETWEEN THE DELIVERY OF THE STATEMENT AND THE EXTENSION OF CREDIT THEREON.

Bankruptcy Act, Section 14, Subdivision B-3;

Ragan, Malone & Co., vs. Cotton & Preston, 200 Fed. Rep. 546;

In re Levinsohn, 223 Fed. Rep. 874;
Haimowich vs. Mandel, 243 Fed. Rep. 338.

POINT II.

THE PROOF ADDUCED BY THE PETITIONER ESTABLISHED THAT THE BANKRUPT, WITH INTENT TO CONCEAL HIS FINANCIAL CONDITION, DESTROYED, CONCEALED OR FAILED TO KEEP BOOKS OF ACCOUNT OF RECORDS FROM WHICH SUCH CONDITION MIGHT BE ASCERTAINED.

Bankruptcy Act, Section 14, Subdivision B-2;
In re: Janowitz, 219 Fed. Rep. 876;
In re: Newburg & Dunham, 209 Fed. Rep. 198;
In res Hanna, 168 Fed. Rep. 238;
In re: Koelle, 171 Fed. Rep. 257.

ARGUMENT ON POINT I.

Sec. 14, sub. B(3) of the Bankruptcy Act provides that a bankrupt may receive his discharge "unless he has * * * obtained money or property on credit upon a materially false statement in writing made by him to any person or his representative for the purpose of obtaining credit from such person."

In re *B. & R. Glove Corporation*, 279 Fed. 372, the precedent relied upon by the Circuit Court of Appeals in deciding the present case, the Court says at page 380:

> "As respects that part of the financial statement in which it was agreed that the debtor would notify the creditor of any material re-

duction of the latter's financial responsibility, it is not to be understood as imposing an obligation unlimited in time, but only during such a reasonable time as the financial statement itself could be relied upon. This case differs materially from that of the *Atlas Shoe Co. vs. Bechard, supra,* upon which the claimant strongly relies. In that case the agreement expressly provided that it might be considered as a continuing statement, 'and a new and original statement of our assets and liabilities upon each and every purchase of goods from them (it) hereafter until we advise them in writing to the contrary'. The Court said:

> " 'This is something more than a representation true at the time and a mere failure to notify of a change of conditions. Such a representation may be relied upon only for a reasonable time. It is here expressly agreed that it may be considered a continuing statement, and a new and original statement upon each and every purchase of goods. That can mean nothing less than that it is to have the same force and effect "as a basis for credit" that it would have if it accompanied each order of goods and was made as of the date of said order. The intention of the parties is apparent and unmistakable that the plaintiff might rely upon it the same when the last as when the first goods were sold.'

"In the instant case the agreement was simply to notify of any material reduction of financial responsibility, which we construe to refer to the period of 'reasonable time' within which the statement itself continued in force."

In the present case, the language of the financial statement is:

> "This statement is to be regarded by Abraham Lustgarten and by the Corn Exchange Bank as continuous and binding and to form a true statement as to the assets and liabilities of the undersigned and other matters to be relied upon by the Corn Exchange Bank upon application by the undersigned for all loans until another statement in writing shall be substituted for this or this statement recalled."

The language of the financial statement of *Atlas Shoe Co. vs. Bechard* is as follows:

> "The above is a true and accurate statement of all our assets and liabilities and is presented to the Atlas Shoe Co. as a basis for credit. This statement may be considered by the Atlas Shoe Co. a continuing statement of our affairs, and a new and original statement of our assets and liabilities upon each and every purchase of goods from them hereafter until we advise them in writing to the contrary."

The Circuit Court of Appeals indicates the distinction between B. & R. Glove Corporation and *Atlas Shoe Co. vs. Bechard* due to the difference in the language of the financial statements but overlooks the fact that the language of the financial statement in the present case is the equivalent of the language of the financial statement in *Atlas Shoe Co. vs. Bechard*. *Atlas Shoe Co. vs. Bechard* and not B. & R. Glove Corporation should be *stare decisis* of this case.

In *Ragan, Malone & Co. vs. Cotton & Preston*, 200 Fed. 546 (Circuit Court of Appeals, Fifth Cir-

cuit), a financial statement was issued which contained the following provision:

> "This statement shall be binding for each purchase now or hereafter made unless changed by written authority from the undersigned."

The Court there says:

> "(1) There is considerable discussion in the briefs as to the effect, legal and moral, of the declaration in the first paragraph of the statement made by Preston, to wit:
>
> > 'This statement shall be binding for each purchase now or hereafter made, unless changed by written authority from the undersigned.'
>
> "And it is argued that, as the bankrupts before adjudication had paid for the first purchase of goods obtained under the statement, Ragan, Malone & Co. had no right to rely upon it as a basis of credit for any subsequent purchase. The account of Ragan, Malone & Co. with the bankrupts appears to be a running account, covering purchases from time to time for a little over one year, on which the credits made at no time left the account fully paid up, so that it is only an assumption, depending upon the correct imputation of payments, to say that the first purchase was ever fully paid for. But, be that as it may, the parties agreed that the statements should be binding for continuous credit. The evidence is that it was relied upon by the creditors in the subsequent credits, as well as in the first, and we know of no reason to go behind the agreement."

In *Haimowich vs. Mandel* (Circuit Court of Appeals, Third Circuit), the Court says:

> "the test of whether a false statement given upon one date and communicated and acted upon on a later date operates as a bar to a discharge, is twofold: (1) Whether the agency was the representative of the prospective creditor at the time the statement was communicated to and acted upon by him; and (2) whether at that time the false statement was still in force and binding upon the bankrupt, to be determined according as it is found that the sale on credit was or was not the proximate result of the statement (In re *Braverman* (D. C.) 199 Fed. 863, 28 Am. Bankr. Rep. 513), and that its original falsity was or was not the thing that worked the mischief."

In re *Levenson*, 223 Fed. Rep. 874, (District Court, Massachusetts) the statement contained a provision that it should be considered as continuing in force and as being a true statement of the bankrupt's financial condition until the trust company was notified to the contrary. The statement was made about December 12, 1911. The next extension of credit thereunder was July 12, 1912. There was no evidence that the bankrupt made any disclosure to the trust company of any change in his financial condition. The Court therefore sustained the objection to the confirmation of the bankrupt's proposed composition upon the ground that he had made a false financial statement.

If we apply the test adopted by the Court in *Haimowich vs. Mandel*, whether the statement's "original falsity was or was not the thing that worked the mischief," there is but one possible con-

clusion from the facts adduced in this case, and that is that the falsity did work the mischief.

Both William C. Horton, the manager of the Corn Exchange Bank, and Charles A. Ingalls, assistant credit manager, testified that they relied upon the financial statement and that the bankrupt had been given a standing line of credit of $15,000 which was originally fixed by the Board of Directors (Rec. pp. 15-22 and 25-30). It thus appears that upon consideration of the statement the Board of Directors of the Corn Exchange Bank originally fixed the bankrupt's credit at $15,000 and on the occasion of the extension of credits, testified to by Mr. Horton and Mr. Ingalls, they referred to the credit file, and, not having received any notice from the bankrupt or from any other source of a change in his financial condition (and the bankrupt being within the credit limits of $15,000), they extended the desired credit.

The practical effect of the decision in B. & R. Glove Corporation is that there is no legal distinction between the ordinary financial statement and what is commonly designated a continuing financial statement; that the attempt of the parties to make a continuing financial statement is ineffectual; and that the language used by the parties in attempting to draft a continuing statement is a nullity.

The Courts must give effect to the intent of the parties evidenced by the language which they use, and the reasoning of the Courts in *Regan, Malone & Co. vs. Cotton & Preston* and *Atlas Shoe Co. vs. Bechard* should be established by this Court as the law on this question.

The facts adduced in this case proved that not only was the statement false at the time of the

extensions of credit in October and November, 1920, and February 11, 1920, but that the statement was originally false when made. On January 5, 1920, upon this false statement, false when it was originally made, the bankrupt established a limit of credit with the Corn Exchange Bank in the sum of $15,000. We again advert to the test applied by the Circuit Court of Appeals in *Haimowich vs. Mandel (supra)*, whether the statement's "original falsity was or was not the thing that worked the mischief." Disregarding the provision whereby the financial statement was made a continuing statement, we find that upon the strength of this originally false statement, the bankrupt had succeeded in causing the Board of Directors of the Corn Exchange Bank to give him a standing credit up to $15,000.

The determination of this question is of great importance to merchants. Upon the authority of the decision of the Circuit Court of Appeals, dishonest debtors may issue flagrantly false statements, obtain credit thereon, pay the first bills contracted during the first few months after the issuance of the statement, fail to pay the later debts contracted on the strength of the false statement, and yet receive a discharge in bankruptcy.

ARGUMENT ON POINT II.

Section 14 subdivision B (3) of the Bankruptcy Act provides that a bankrupt may receive his discharge "unless he has * * * with intent to conceal his financial condition, destroyed, concealed or failed to keep books of account from which such condition might be ascertained * * *."

The bankrupt testified that he employed his nephew, Louis Lustgarten, for a period of about

nine or ten years prior to the bankruptcy under a verbal agreement; that during the years 1919 and 1920, he deducted the sum of $20 a week from the salary paid to Louis Lustgarten for saving purposes, with the understanding that at any time the nephew required the money it would be paid; that during the month of December, 1920, the nephew requested the money and thereupon he was paid the sum of $1,000 on December 8th, and $1,000 on December 22nd, 1920; that the name of Louis Lustgarten did not appear in the salesmen's commission book because the only names appearing in the salesmen's commission book are those who receive a commission, and that Louis Lustgarten was a salaried man (Rec. p. 65).

The accountant called as a witness by the trustee testified that the name of Louis Lustgarten did not appear in the book of accounts with salesmen; but there appeared to be an entry of a payment to Louis Lustgarten in the general ledger under the heading "commissions on sales" posted from the cash book, and that nowhere does any entry appear in the books to offset the entries of these payments (Rec. p. 23).

The Circuit Court of Appeals, in its opinion commenting on this subject, states:

> "The most that is argued is that the books did not contain credit entries to offset these debits. Accurate bookkeeping would have required a proper credit entry of $20.00 weekly—a small amount as compared with the volume of business of the bankrupt. In the statement to the bank, the liabilities for merchandise and bank accommodations are carefully and accurately set forth; and the failure to note

> these small credit entries was due to inadvertent faulty bookkeeping and not to any intent to conceal financial conditions" (Rec. p. 74).

We respectfully submit that the learned Court below overlooked this important factor in connection with the bookkeeping entries, namely, that, while the pretense for the payment made by the bankrupt to his nephew is an alleged indebtedness for moneys deducted from salary for purposes of savings, the payment is posted in the general ledger under the heading of "Commissions on Sales." The bankrupt testified as above pointed out, that Louis Lustgarten was a salaried man and not a salesman upon commissions. The posting of the payment to Louis Lustgarten under the heading of "Commissions on Sales" could have had but one purpose.

A creditor examining the books of the bankrupt on December 8th, when the entry was made, would have been misled into believing that the $1,000 payment to Louis Lustgarten was a payment on account of commissions which the said Louis Lustgarten earned as a salesman, and the existence of a balance of indebtedness in the sum of $1,000 would not have been disclosed, nor would the creditors have learned that any indebtedness whatsoever existed from the bankrupt to Louis Lustgarten.

In re *Janowitz*, 219 Fed. 876, the Circuit Court of Appeals, Third Circuit, it is said:

> "The object of the statutory provision is to make it easy to ascertain the bankrupt's financial condition."

In *Newbury & Dunham*, 209 Fed. 195, 197, the Circuit Court of Appeals, Second Circuit, says:

> "The burden was on the bankrupts to explain these admittedly false statements and they have failed to do so. The policy of the law is to deny a discharge to a bankrupt who entirely fails to comply with its requirements. When a trader doing a large business fails to keep books or records from which his financial condition can be ascertained, the law, in the absence of any reasonable explanation, will presume an intent to conceal. No other inference can justly be drawn."

Obviously the entry of the payments to the nephew under the heading of "Commissions on sales" precludes any inference other than that of intent to conceal—either to conceal an indebtedness that he owed to his nephew, or, to conceal the withdrawal of moneys under the guise, of commissions paid to a salesman and to withhold the moneys so withdrawn from the trustee in bankruptcy.

In re *Hanna*, 168 Fed. 238, 240, the Circuit Court of Appeals, Second Circuit, speaking of this provision of the amended act, says:

> "Obviously the present reading is much more exacting, and is intended to prevent a bankrupt from obtaining a discharge, if he, whether in contemplation of bankruptcy or not, for any reason, fraudulent or otherwise, has kept his books with intent to conceal his financial condition. A provision intended to insure the keeping of correct and complete accounts should be rigidly enforced, especially one whose operation is made to depend upon intention, excluding mistake or neglect."

The failure to enter confidential debts to relatives was condemned in the following cases:

In re *Hanna,* 168 Fed. Rep. 238;
In re *Koelle,* 171 Fed. Rep. 257.

THE DECREE OF THE CIRCUIT COURT OF APPEALS SHOULD BE REVERSED AND THE BANKRUPT'S PETITION FOR DISCHARGE DENIED.

Respectfully submitted,

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Attorney for Petitioner.